Office-Supreme Court, U.S.
FILED
FEB 27 1981
ALEXANDER L. STEVAS,
CLERK

80-1484
No.

In the
Supreme Court of the United States
OCTOBER TERM, 1980

U.S. STEEL CREDIT CORPORATION,
Petitioner,

vs.

AMERICAN FLETCHER MORTGAGE COMPANY, INC., AMERICAN FLETCHER NATIONAL BANK AND TRUST COMPANY, and AMERICAN FLETCHER CORPORATION,
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT
(Seventh Circuit Nos. 80-1485, 80-1719)

WILLIAM A. WICK
1000 Merchants Bank Bldg.
11 South Meridian Street
Indianapolis, Indiana 46204
(317) 632-1348
Attorney for Petitioner

Of Counsel for Petitioner:
NICHOLAS C. NIZAMOFF
WHITE, RAUB, REIS, WICK & RIEGNER
1000 Merchants Bank Building
11 South Meridian Street
Indianapolis, Indiana 46204

The Scheffer Press, Inc.—(312) 263-6850

QUESTIONS PRESENTED

1. Did the Court of Appeals err in affirming the District Court's judgment dismissing the securities fraud counts of Petitioner's counterclaim on the ground that Petitioner's participation shares in mortgage loan notes held by the Respondent Mortgage Company were not "securities" under the federal securities acts?

2. Did the Court of Appeals err in concluding that a participation share in a mortgage loan note held by a commercial lender is not an "investment" within the meaning of the Supreme Court's *Howey* and *Forman* decisions?

3. Did the Court of Appeals err in concluding that Petitioner's anticipated share of any interest paid on the loans was not an "expectation of profits" under the *Howey* and *Forman* decisions, because, said the Court of Appeals, "the rate of return was [not] in any way dependent on the actual profits, if any, of the project"?

4. Did the Court of Appeals err in concluding that under the *Howey* and *Forman* decisions the expected return on a mortgage loan participation is not "derived from the entrepreneurial or managerial efforts of others", if the investment decision is based in part on the participant's own business judgment and if the participation agreement prohibited modification of the loan or release of the collateral without participant's consent and authorized the participant to compel foreclosure in the event of a default?

TABLE OF CONTENTS

	PAGE
Report of Opinion	vi
Jurisdictional grounds	vi
Applicable statutes	vi
Statement of the case	1
Argument	10
A. Seven reasons for granting petition	10
B. Whether or not the notes were "investments" by Respondent Mortgage Company, Petitioner's participations therein were "investments"	14
C. Petitioner's expected return on its participations was an expectation of "profits" under *Howey-Forman*	16
D. As a participant, Petitioner necessarily looked to the "entrepreneurial or managerial efforts" of the Respondent Mortgage Company for any profits on the Cromwell participations	18

TABLE OF AUTHORITIES

Cases

	PAGE
Aaron v. *SEC*, ... U.S. ....., 100 S.Ct. 1945 (1980)	11, 14
CNS Enterprises, Inc. v. *G & G Enterprises, Inc.*, 508 F.2d 1354 (7th Cir. 1975)	21
Canadian Imperial Bank of Commerce Trust Co. v. *Fingland*, 615 F.2d 465 (7th Cir. 1980)	16
Commercial Discount Corp. v. *Lincoln First Commercial Corp.*, 445 F.Supp. 1263 (S.D.N.Y. 1978)	13, 22
Eason v. *General Motors Acceptance Corporation*, 490 F.2d 654 (7th Cir. 1973)	11

PAGE

Emisco Industries, Inc. v. *Pro's Inc.*, 543 F.2d 38 (7th Cir. 1976) 13

Exchange National Bank v. *Touche Ross & Co.*, 544 F.2d 1126 (2nd Cir. 1976) 12

FBS Financial v. *CleveTrust Realty Investors*, Fed. Sec. L. Rep. (CCH) ¶96,341 (N.D.Ohio 1977) 14

Goodman v. *Epstein*, 582 F.2d 388 (7th Cir. 1978) 13

Great Western Bank & Trust v. *Kotz*, 532 F.2d 1252 (9th Cir. 1976) 24

In re Yale Express System, Inc., 245 F.Supp. 790 (S.D.N.Y. 1965) 18

International Brotherhood of Teamsters v. *Daniel*, 439 U.S. 551, 99 S.Ct. 790 (1979) 16

Lehigh Valley Trust Co. v. *Central National Bank of Jacksonville*, 409 F.2d 989 (5th Cir. 1969) 13, 22

Lincoln National Bank v. *Herber*, 604 F.2d 1032 (1979) 15

NBI Mortgage Investment Corp. v. *Chemical Bank* [1976-1977] Fed. Sec. L. Rep. (CCH) ¶95,632 (SDNY 1978) [1977-1978] Fed. Sec. L. Rep. ¶96,066 (SDNY 1977) 13

Provident Nat. Bank v. *Frankford Trust Co.*, 468 F.Supp. 448 (E.D.Pa. 1979) 14

Rubin v. *United States*, 41 CCH S.Ct. Bull. p. B824 (1981) 15

SEC v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 84 S.Ct. 275 (1963) 14

SEC v. *Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir. 1973) 20

SEC v. *W. J. Howey*, 328 U.S. 293, 66 S.Ct. 1100 (1946) 11, 15-16, 20-21

PAGE

Tcherepnin v. *Knight*, 389 U.S. 332, 88 S.Ct. 548 (1967) 11, 16, 17

United American Bank of Nashville v. *Gunter*, 620 F.2d 1108 (5th Cir. 1980) 13

United California Bank v. *THC Financial Corp.*, 557 F.2d 1351 (9th Cir. 1977) 22

United Housing Foundation v. *Forman*, 421 U.S. 837, 95 S.Ct. 2051 (1975) 11, 12, 15, 17, 18, 20, 21, 25

United States v. *Naftalin*, 441 U.S. 768, 99 S.Ct. 2077 (1979) 10

Williamson v. *Tucker*, 632 F.2d 579 (1980) 17

Statutes

Securities Act of 1933 - 15 U.S.C. §77(b)(1) vi

Securities Exchange Act of 1934 - 15 U.S.C. §78c (a)(10) ..... vi, vii

28 U.S.C. §1254 vi

28 U.S.C. §1331 3

28 U.S.C. §1332(a) 3

28 U.S.C. §2101(c) vi

Rules

Rule 12(b)(6) F.R.Civ.P. 19

Supreme Court Rule 20.4 vi

Other Authorities

Bank Loan Participations: The Affirmative Duty to Disclose Under SEC Rule 10b-5, 27 Syracuse L.Rev., 807, 816 (Spring, 1976) 23

PAGE

Janik, The Colocotronis Dispute: When is a Loan Participation Share a Security, 13 J. Int'l. Law & Econ. 165 (1978) 18

Loan Participations as Securities, 8 Cal. W. Int'l. L. J. 510 (1978) 23

S. Rep. No. 47, 73d Cong., 1st Sess., to accompany S.875, April 27, 1933 14

Webster's New International Dictionary Unabridged (3rd Ed., 1965) 15

REPORT OF OPINION

The opinion of the United States Court of Appeals for the Seventh Circuit in this case has not yet been reported.

JURISDICTIONAL GROUNDS

The judgment and opinion of the United States Court of Appeals for the Seventh Circuit were rendered on November 3, 1980, and Petitioner's timely petition for re-hearing was denied on December 3, 1980.

Jurisdiction to review the Court of Appeals decision by writ of certiorari resides in the Supreme Court under 28 U.S.C. §1254 and is timely invoked pursuant to 28 U.S.C. §2101(c), as interpreted by Supreme Court Rule 20.4.

APPLICABLE STATUTES

At issue in this case are the substantially identical definitions of a "security" under the Securities Act of 1933 [15 U.S.C. §77b(1)], and the Securities Exchange Act of 1934 [15 U.S.C. §78c(a)(10)]:

> "When used in this title unless the context otherwise requires—
>
> "(1) The term 'security' means, any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest

or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. [15 U.S.C. §77b(1)]

"When used in this title unless the context otherwise requires—

"(10) The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance, which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." (15 U.S.C. §78c(a)(10))

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1980

No.

U.S. STEEL CREDIT CORPORATION,

Petitioner,

vs.

AMERICAN FLETCHER MORTGAGE COMPANY, INC., AMERICAN FLETCHER NATIONAL BANK AND TRUST COMPANY, and AMERICAN FLETCHER CORPORATION,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT
(Seventh Circuit Nos. 80-1485, 80-1719)

STATEMENT OF THE CASE

This Petition for Certiorari seeks reviews by the Supreme Court of a decision of the United States Court of Appeals for the Seventh Circuit affirming a judgment of the United States District Court for the Southern District of Indiana, Indianapolis Division.[1] The sole ground of

---

[1] Although there were several interlocutory orders of the District Court also involved in the appeal to the Seventh Circuit, the instant Petition seeks review of the Seventh Circuit's decision only insofar as it affirmed the District Court's judgment dismissing federal securities fraud counts of Petitioner's counterclaim against the Respondents and its Order denying Petitioner's motion for partial summary judgment on such securities counts.

the judgment and order in question was that certain participation shares acquired by Petitioner in mortgage loan notes held by Respondent, American Fletcher Mortgage Company, Inc. (the "Mortgage Company") did not qualify as "securities" under the applicable securities acts.

The instant litigation originated as two separate lawsuits filed on the same date, one filed by Petitioner against the Respondents in United States District Court for the Western District of Pennsylvania and the other by the Respondent Mortgage Company against Petitioner, U. S. Steel Credit Corporation ("USSC"), in the Indianapolis Division of the United States District Court for the Southern District of Indiana. Petitioner's Pittsburgh suit was for federal securities fraud in connection with the acquisition by Petitioner from the Mortgage Company of 40% participation shares in mortgage loans made by the Mortgage Company for the development and construction of a condominium project at Cromwell, Connecticut. Respondents, American Fletcher National Bank and Trust Company (the "Bank") and the parent corporation, American Fletcher Corporation ("AFC"), were charged with securities fraud liability, as "controlling persons" and "aiders and abettors" of the Mortgage Company.[2]

The Mortgage Company's Indianapolis suit was for alleged breach by Petitioner, USSC, of its commitment

---

[2] The Pittsburgh suit also included counts for common law fraud and breach of the participation agreements, but those counts are not relevant to the instant Petition.

under the participation agreements to fund in full its share of the loan and certain related expenses.[3]

The District Court's jurisdiction of the Pittsburgh suit was based on federal question jurisdiction under 28 U.S.C. §1331, and jurisdiction of both suits was also based on diversity of citizenship under 28 U.S.C. §1332 (a).

The Pittsburgh suit was subsequently transferred to the District Court in Indianapolis, where it was consolidated with the Indianapolis suit. Since the issues in both suits were substantially the same, the action originally filed in Pittsburgh was thereafter dismissed and the counts of the Pittsburgh complaint were embodied in an amended counterclaim in the Indianapolis suit (App. pp. 28a-41a).

The events which led up to the instant litigation, as set forth in Petitioner's amended counterclaim[4] and in deposition testimony referred to in affidavits submitted with Petitioner's motion for partial summary judgment (App. pp. 77a-78a), were as follows.

In October, 1973, Petitioner received from the Mortgage Company 40% participation offerings in a $2,530,000 Land Acquisition and Development Loan (the "L&D

---

[3] By subsequent amendment of the Indianapolis complaint, the Bank was added as a co-plaintiff, asserting rights as an alleged third-party beneficiary of the participation agreements and claims for interference with contractual relations, none of which rights or claims are at issue in this Petition.

[4] Since the District Court granted the Mortgage Company's motion to dismiss the "securities" counts (App. pp. 16a-22a), the facts set forth in the counterclaim must be taken as true, as well as the uncontroverted facts referred to in affidavits submitted by Petitioner.

Loan") and a $3,290,000 Construction Loan, which in March, 1973, the Mortgage Company had committed itself to make to a New York developer, Justin Development Corp. for the purchase, development and construction of a condominium complex in the Town of Cromwell, Connecticut. These loans were designed to cover the entire cost of land acquisition, development and first phase construction of the project.

In processing a loan, the Mortgage Company's practice was to obtain all pertinent information on the project, including appraisals, site survey, engineering and architectural plans and specifications, and market analysis; financial and other pertinent information on the borrower and its principal officers; similar information on the contractor, including the contractor's bonding capability; and full cost information, including estimated construction costs and cost breakdowns. (Trepinski dep., App. pp. 86a-88a). The Mortgage Company would then negotiate the terms of the loan with the borrower to fit the estimated costs, prepare the necessary documentation and issue loan commitments. (App. pp. 86a-88a)

In the case of the Cromwell L&D Loan, the Mortgage Company, prior to submitting its participation offering to Petitioner, entered into a written loan agreement with Justin Development Corp. and advanced to Justin major sums of its own money. The Mortgage Company then assembled the information it had gathered and submitted the same to Petitioner along with the participation offerings.

The participation offerings represented the Cromwell project as ultimately involving a total of 450 condominium units, of which 150 units were to be constructed in the

first phase of the project. The three-year mortgage loans were to be at "floating" rates of 5% over prime in the case of the L&D Loan, and 4% over prime in the case of the Construction Loan. The offerings also indicated that a 50% participation share had been offered to American Fletcher Mortgage Investors (the "Trust"), a Massachusetts real estate investors trust, and a 10% share to the Mortgage Company's affiliate, American Fletcher National Bank (App. pp. 41a-45a).

Unlike the Mortgage Company, Petitioner, USSC, was not staffed to originate or manage major real estate development loans (Thomas dep., App. pp. 81a-82a). Instead, USSC was engaged in the business of raising money, largely through the sale of commercial paper, and investing in loan participations like the Cromwell project (Mack dep., App. p. 80a). Generally, USSC's practice was to acquire minority participations in loans in which the lead bank had retained a major share (Thomas dep., App. p. 82a).

On the question of reliance upon the lead bank, Petitioner's representatives pointed out that a major factor was the reputation of the lead bank and the fact that the lead had substantial sums of its own money at stake (Lang dep., App. p. 81a; Thomas dep., App. p. 82a; Mack dep., App. pp. 80a-83a). There was further testimony on the management functions which were expected of a lead bank in the course of administration of a loan, e.g., periodic inspections of the progress of the work, obtaining certifications from inspecting architects or engineers, monitoring of disbursements to insure proper application of loan funds, periodic comparison of unconsumed loan balances with estimated cost to complete, negotiations with borrower to resolve any problems that might arise and

notification to participants of any problems (Mack dep., App. pp. 84a-85a). Of course, Petitioner also relied on the lead bank to see to it that the loans were properly closed and loan documents properly executed (Mack dep., App. p. 85a).

After studying the participation offerings and the data supplied by the Mortgage Company and visiting the Cromwell site, but with reliance upon the truth, accuracy and completeness of the Mortgage Company's material representations and disclosures (Counterclaim ¶¶6-11, App. pp. 29a-35a) Petitioner prepared, executed and sent the participation agreements to the Mortgage Company for signature. These were subsequently executed by the Mortgage Company under date of December 31, 1973 (see Participation Agreement, App. pp. 45a-52a).

In effect, the participation agreements involved the acquisition by Petitioner of 40% shares of whatever amounts the Mortgage Company might recover on the Cromwell loans, whether by payments on the notes, by foreclosure against the security, or otherwise.

These agreements required the Mortgage Company to hold in trust, for the benefit of Petitioner, the notes, the security, all instruments related to the loan obligation and all proceeds and avails thereof, while prohibiting the Mortgage Company from modifying the terms of the loan obligation or releasing any of the security without written consent of Petitioner.

The participation agreements established a procedure for advance notification to Petitioner of amounts due from Petitioner as its share of proposed disbursements on the loan and provided that such notification would be deemed a representation by the Mortgage Company that there

was no material breach of the loan agreement of which the Mortgage Company was aware.

The Mortgage Company was required to "administer" the loan obligation in accordance with the terms of the Loan Agreements, but the Mortgage Company's liability for loan mismanagement was limited to willful misconduct, bad faith or gross negligence.

Provision was also made for prompt notice to Petitioner by the Mortgage Company of any material default in the terms of the loan obligation or any other matter which, in the Mortgage Company's judgment, adversely affected Petitioner's interest.

The agreements went on to provide that in the event of any material default, the Mortgage Company shall exercise all of its rights to enforce collection of the loan obligation either upon its own initiative or upon request of Petitioner.

The participation agreements prohibited any sale or other dispostion by the Mortgage Company or by Petitioner of the note or the participation, but authorized the Mortgage Company to redeem Petitioner's participation by payment to Petitioner of all amounts due upon the same.

Neither party to the Participation Agreements construed the same as vesting in Petitioner any interest in the unpaid loan or any rights against Justin Development Corp., the borrower. (Mack Supp. Aff., App. p. 91a).

The counterclaim with detailed particularity, charges the Mortgage Company with more than fifteen deliberate or reckless misrepresentations or non-disclosures of material fact (Counterclaim ¶¶6-9, App. pp. 29a-34a), notably:

1. That over a sixteen months period from the date of closing of the Construction Loan in February, 1974, until mid-June, 1975, the Mortgage Company collected more than $2,000,000 from USSC without disclosing to USSC that disbursements on the loan were not legally obligatory because the borrower had failed to comply with the express conditions of the loan agreement that it submit a proper construction contract and performance bond. (Counterclaim ¶7, App. p. 30a);

2. That the Mortgage Company failed to disclose to USSC that it had thrown the Construction Loan out of balance by advancing to the borrower the amount of interest payments on the Construction Loan, despite the fact that there were no funds budgeted for the payment of interest under the Construction Loan. (Counterclaim ¶9(a), App. p. 31a);

3. That the Mortgage Company failed to disclose to USSC that prior to the closing of the Construction Loan, the Mortgage Company's legal counsel in charge of closing and administering the loan had warned that the loan would be inadequate to complete development and construction of the first phase of the Cromwell project. (Counterclaim ¶9(i), App. p. 33a).

On January 7, 1980, the Mortgage Company filed a Motion to Dismiss or for Judgment on the Pleadings as to Securities Law Claims (App. pp. 75a-76a).

USSC responded on February 22, 1980, with a Cross-Motion for a partial summary judgment declaring its participations to be "securities" under federal and state securities acts (App. pp. 77a-78a).

On March 21, 1980, the District Court issued an Order granting the Mortgage Company's Motion to Dismiss or for Judgment on the Pleadings on the securities counts of USSC's counterclaim, and at the same time denied USSC's Cross-Motion (App. pp. 16a-22a). This Order, as amended to include a Rule 54(b), F.R.Civ.P., certification and direction for entry of final judgment (App. pp. 23a-25a), was affirmed by the Court of Appeals, precipitating the instant Petition.

ARGUMENT

A. Seven Reasons for Granting Petition.

1. As inflation accelerates and the number of multi-million dollar development and construction loans multiplies, more and more lenders are raising capital and spreading risks by selling loan participations. These are often sold to distant participants, who have little independent knowledge of the borrowers or of the projects for which they seek to borrow, and who must, therefore, rely upon the lead bank to investigate, evaluate and negotiate loans sufficient for the borrowers' financial needs; to supply prospective participants with complete and accurate information sufficient for intelligent investment decisions; to manage the loans once consummated; to supervise the application of loan funds, and to monitor the progress of the work for which the funds are loaned.

It thus becomes a matter of increasing national importance for the Supreme Court to resolve the question, whether and to what extent participation shareholders are entitled to the protection of the federal securities acts.

2. It is submitted that decisions like the Seventh Circuit's decision, below, spring from the tacit belief that major corporate investors do not need the protection of the securities acts. This theory has led to distortions of the Supreme Court's guidelines for testing securities status and to frustration of the Congressional intent reflected in the Securities Acts. None of these guidelines or enactments suggests any purpose to limit the Acts to small or unsophisticated investors. To the contrary, see *United States* v. *Naftalin,* 441 U.S. 768, 99 S.Ct. 2077 (1979).

While unsophisticated investors are, perhaps, more easily duped, it does not follow that major investors need no securities act protection. First, the absence of such protection tends to dry up this important source of capital. Secondly, practical necessities require that loan participants, with millions entrusted to their lead banks, must have faith and confidence in their leads and avoid the disruptive effect of policing their leads for potential misconduct or mismanagement. Finally, one must remember that losses suffered by corporate investors for want of securities act protection will ultimately devolve upon their shareholders, often small investors of modest means. See *Eason* v. *General Motors Acceptance Corporation,* 490 F.2d 654, 657 (7th Cir. 1973)

3. Contrary to the Supreme Court's repeated admonitions that the Securities Acts should be construed broadly and flexibly to achieve their remedial purposes [*Tcherepnin* v. *Knight,* 389 U.S. 332, 336, 88 S.Ct. 548, 553 (1967); *Aaron* v. *SEC,* 100 S.Ct. 1945, 1960 (1980)], the instant decision of the Seventh Circuit narrowly construes the Supreme Court's guidelines for determining securities status by ruling that interest is not a form of "profits" and by restrictively applying the *Howey-Forman* profits-derivation test.[5]

4. Contrary to the Supreme Court's admonition in *Forman,* 421 U.S. 837, 848, 95 S.Ct. 2051, 2058 (1975) that in construing the term, "security," "form should be disregarded for substance and the emphasis should be upon economic reality," the Court of Appeals held that interest was not "profits" because the rate of return on

[5] See *SEC* v. *W. J. Howey,* 328 U.S. 293, 301, 66 S.Ct. 1100, 1104 (1946); *United Housing Foundation* v. *Forman,* 421 U.S. 837, 852, 95 S.Ct. 2051, 2060 (1975).

the notes was wholly independent of any profits (App. p. 13a), ignoring the "economic reality" that without profits there would be no return on these notes.

5. In holding that where a prospective loan participant's expectation of profits derives in part from the participant's own evaluation of the investment opportunity, there is no "expectation of profits to be derived from the entrepreneurial or managerial efforts of others" within the meaning of *Forman, supra,* 421 U.S. p. 853 (App. p. 14a), the Court of Appeals misconceived the profits-derivation test in two respects: first, in regarding the "efforts of others" requirement as looking to the source of the *expectation* of profits rather than merely to the source of the profits, and, secondly, by construing *Forman* as requiring that the profits *expectation* must derive *solely* from the "efforts of others."

The Supreme Court's *Howey-Forman* formulation is in need of clarification on this point.

6. Likewise, the Court of Appeals' holding (App. p. 14a) that Petitioner's reservation under the participation agreements of rights to prohibit changes in loan terms or release of the security and to demand foreclosure in case of default precluded any inference of reliance upon the managerial efforts of others, would disqualify, for example, a corporate mortgage bond as a "security," since all of the above rights are possessed by bondholders.

7. While the Second Circuit has not ruled on the precise question, whether a loan participation is a "security," its liberal approach to the "securities" Acts definitions, as formulated in *Exchange National Bank* v. *Touche Ross & Co.,* 544 F.2d 1126 (2nd Cir. 1976), stands in marked contrast to the restrictive interpretation of the Seventh and some other Circuits.

Touche Ross reflects a disposition to give broad scope to the Securities Acts—as, indeed, the Supreme Court has urged—by presuming instruments, expressly defined as "securities," to be what Congress says they are, unless the opposing party sustains the burden of proving that "the context[6] otherwise requires." Following this approach, two District Court decisions in the Second Circuit have held loan participations to be "securities." *Commercial Discount Corp.* v. *Lincoln First Commercial Corp.,* 445 F.Supp. 1263 (SDNY 1978) and *NBI Mortgage Investment Corp.* v. *Chemical Bank,* [1976-1977] Fed. Sec. L. Rep. (CCH) ¶95,632 (SDNY 1978) and [1977-1978] Fed. Sec. L. Rep. ¶96,066 (SDNY 1977).

Unlike *Lehigh Valley Trust Co.* v. *Central National Bank of Jacksonville,* 409 F.2d 989 (5th Cir. 1969)[7], the

---

[6] "Context" looks to "surrounding factual circumstances" [*Emisco Industries, Inc.* v. *Pro's Inc.,* 543 F.2d 38, 39 (7th Cir. 1976)] including "the actual facts and circumstances of the investment arrangement", *Goodman* v. *Epstein,* 582 F.2d 388, 406 (7th Cir. 1978).

[7] *Lehigh Valley* held that a loan participation was a "security" because so defined in the Acts. Though its literal approach has been repudiated, it reached the correct result on the facts described in the opinion. Recently, in *United American Bank of Nashville* v. *Gunter,* 620 F.2d 1108 (5th Cir. 1980), the Fifth Circuit affirmed a District Court holding that loan participations were not within the Securities Acts. *Gunter,* however, presented peculiar facts in that the participant and the lead bank were affiliates, and, as a matter of routine, the participant took whatever participations the lead offered from time to time without question or expectation that the lead would keep it informed of material facts. Thus, there was no reliance by the participant on representations or disclosures of the lead which could support a securities fraud claim. In affirming, *per curiam,* the District Court in Nashville, the Fifth Circuit, significantly, disavowed approval (fn. 2,

Second Circuit's approach gives full consideration to the "context," but resolves doubts in favor of *inclusion*. The Seventh Circuit, by contrast, resolves doubt, in favor of *exclusion*.

B. Whether or not the Notes Were "Investments" by Respondent Mortgage Company, Petitioner's Participations therein were "Investments."

The Supreme Court has repeatedly emphasized that federal securities legislation should be construed, "not technically and restrictively, but flexibly to effectuate its remedial purposes," *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195, 84 S.Ct. 275, 285 (1963); *Aaron* v. *SEC*, ... U.S. ....., 100 S.Ct. 1945, 1960 (1980). The purpose of the Securities Acts was summarized in the Senate Report on the Bill for the 1933 Act, as follows:

> The purpose of this Bill is to protect the investing public and honest business. The basic policy is that of informing the investor of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation, S. Rep. No. 47, 73d Cong., 1st Sess., to accompany S. 875, April 27, 1933.

The Supreme Court's fourfold guidelines for testing "security" status, as initially laid down in *SEC* v. *W. J.*

---

[7] (Continued)
620 F.2d p. 1110) of two other District Court decisions on which the District Court in Nashville had based its holding that participations were not "securities." The District Court decisions in question were *FBS Financial* v. *CleveTrust Realty Investors*, Fed. Sec. L. Rep. (CCH) ¶96,341 (N.D.Ohio 1977), and *Provident Nat. Bank* v. *Frankford Trust Co.*, 468 F.Supp. 448 (E.D.Pa. 1979), both relied upon by the District Court, below, in the case at bar.

Howey, 328 U.S. 293, 301, 66 S.Ct. 1100, 1104 (1946), was further refined in *United Housing Foundation* v. *Forman*:

> The touchstone is the presence of [1] an investment in [2] a common venture premised on [3] a reasonable expectation of profits to be derived from [4] the entrepreneurial or managerial efforts of others.
> 421 U.S. at 852, 95 S.Ct. at 2060

Accordingly, the initial question is whether Petitioner's Cromwell participations were "investments." Like the District Court, the Seventh Circuit concluded that the Cromwell participations met none but the "common venture" test of *Howey-Forman* (App. p. 12a). No explanation was offered for denying that the participations were "investments." In common usage, an "investment" is "an expenditure of money for income or profit", Webster's New International Dictionary Unabridged (3rd Ed., 1965). Assuming that *Howey-Forman* used the term in that broad sense, one may "invest" in a non-security, and there may be "security" transactions, e.g. gifts, which involve no "investment".[8]

It is submitted that *Howey-Forman* intended to characterize as an "investment" any profit-motivated expenditure, even one not involving the acquisition of a "security" by reason of other aspects of the *Howey-Forman* test. That profit-motivation is the key to an investment is consistent with the holdings of *United Housing Foundation* v. *Forman,* 421 U.S. 837, 95 S.Ct. 2051 (1975) that

---

[8] Illustrative of a "securities" transaction not involving an "investment", was *Lincoln National Bank* v. *Herber,* 604 F.2d 1038 (1979), where the Seventh Circuit held that a pledge of stock to secure a loan was not within the Securities Acts. *Herber* has been repudiated, however, by the Supreme Court's recent decision in *Rubin* v. *United States,* ..... U.S. ....., 41 CCH S.Ct. Bull. p. B824 (1981).

housing co-op "stock certificates" did not qualify, where purchasers were motivated by a desire for housing, rather than profits, and by *International Brotherhood of Teamsters* v. *Daniel,* 439 U.S. 551, 99 S.Ct. 790 (1979), holding that union pension funds were not securities, where the inducement was employment, rather than pension profits. In *Tcherepnin* v. *Knight,* 389 U.S. 332, 88 S.Ct. 548 (1967), on the other hand, savings and loan certificates were held to be covered, when acquired for profit.

C. Petitioner's Expected Return on its Participations was an Expectation of "Profits" under Howey-Forman.

The Seventh Circuit's holding to the contrary was based upon the following rationale:

> "Steel [Petitioner] was not to participate in any of the profits from the Justin project, and neither the repayment of the loan nor the rate of return was in any way dependent on the actual profits, if any, of the project". (App. p. 13a)

This reasoning is faulty in several respects. First, the statement that the "rate of return" was not dependent upon profits is true of any interest-bearing instrument. To regard this fact as disqualifying is, in effect, to read out of the Securities Acts interest-bearing instruments, such as notes, participations and certificates of deposit,[9] which Congress expressly included in its broad definitions of "securities."

---

[9] See *Canadian Imperial Bank of Commerce Trust Co.* v. *Fingland,* 615 F.2d 465 (7th Cir. 1980), holding that certificates of deposit were not "securities", largely on the theory that interest was not "profits".

Secondly, to say that the rate of return was not dependent on profits, is true only in a legal sense. As directed in *Forman*, however, in construing the Securities Acts, "form should be disregarded for substance and the emphasis should be upon economic reality". 421 U.S. at 848. The "economic reality" of 100% loans like the Cromwell loans is that in the absence of profits, there will be no return of either principal or interest on the notes. Though apparently lost on the Seventh Circuit, this point was recognized by the Fifth Circuit in *Williamson* v. *Tucker*, 632 F.2d 579, 604 (5th Cir. 1980):

> But a note holder may nevertheless be *dependent* on the *profitability* of the enterprise for the payment of interest or the return of principal. Unless the note holder's reliance on the success of the enterprise is insignificant, the holder can be said, in effect, to share in the profits of the enterprise in the sense contemplated by the Supreme Court in *Forman* (Emphasis the Court's).

Third, consistent with its policy of construing the Securities Acts broadly, the Supreme Court in *Tcherepnin* v. *Knight*, 389 U.S. 332, 338, 88 S.Ct. 548, 554 (1967) expressly described as "profit" the interest return upon the loans of a savings and loan association. Holding that withdrawable certificates in a savings and loan association were "securities", the Court stated in *Tcherepnin*:

> Petitioners are participants in a common enterprise —a *money lending operation* dependent for its success upon the skill and efforts of the management of City Savings in making sound loans . . . [T]he petitioners can expect a return on their investment only if City Savings shows a *profit*. (Emphasis added.) 389 U.S. at 339, 88 S.Ct. at 55

Whether or not commercial loan notes in the hands of a commecial lender qualify as "securities" under the profits-derivation test of *Howey-Forman,* there is no justification for disqualifying them by narrowly defining "profits" to exclude interest.

Fourth, the lender's expected return on its notes must be differentiated from the participant's expected return on its participations. The lender has an absolute right of repayment of principal and interest on the notes. The participant, by contrast, has no rights against the borrower. The participant's sole right is to share in whatever return, *if any,* the lead bank realizes on its note. See *In Re Yale Express System, Inc.,* 245 F.Supp. 790, 792 (SDNY 1965), so holding. As stated in *Janik, The Colocotronis Dispute: When is a Loan Participation Share a Security,* 13 J. Int'l. Law & Econ. 165, 179 (1978):

> Finally, it is critically important to always recall that the participants, holding no notes, had no right against the Colocotronis group [borrowers]. These factors clearly indicate that even though their money was used by a borrower, the participants were not loaning their funds; they were investing their funds.

D. As a Participant, Petitioner Necessarily Looked to the "Entrepreneurial or Managerial Efforts" of the Respondent Mortgage Company for any Profits on the Cromwell Participations.

The fourth element of the *Howey-Forman* test is somewhat ambiguous. This fourth element stipulates that the reasonable expectation of profits is "to be derived from the entrepreneurial or managerial efforts of others", *United Housing Foundation* v. *Forman,* 421 U.S. 837, 852, 95 S.Ct. 2051, 2060 (1975). Does this profits-deriva-

tion test look only to the derivation of the future profits, or to the derivation of the profits *expectation*, or to both?

It will be recognized that if "efforts of others" must be the source, not only of the future profits, but also of the investor's *expectation* of profits that prompts his investment, few investments will qualify as "securities." This follows because every prudent investor relies in part—and often in large part—on his own evaluation of the prospective investment. Is it, then, the policy of the Securities Acts to protect only *imprudent* investors, and penalize those who look before they leap? Apparently, that is how the Seventh Circuit construed the profits-derivation test when it ruled that Petitioner was not "dependent upon the Mortgage Company's entrepreneurial efforts", because "Steel's decision to enter the participation agreement was based on its own business judgment" (App. p. 14a).[10]

---

[10] If this was a finding that Petitioner did *not* rely upon the truth, accuracy and completeness of the material representations and disclosures presented by the Mortgage Company as inducements to Petitioner to purchase its participations and to continue disbursements under them, then it was a wholly improper finding on a disputed issue of material fact. The judgment dismissing the securities counts of Petitioner's counterclaim was a judgment on a Rule 12(b)(6) F.R.civ.P., motion to dismiss, under which the factual averments of the pleadings sought to be dismissed must be taken as true, except to the extent controverted by any evidentiary matter considered by the Court. Petitioner's counterclaim includes an averment that Petitioner did rely to its detriment upon the truth, accuracy and completeness of the Mortgage Company's representations and disclosures. The deposition testimony that Petitioner visited the job site and studied the material submitted by the Mortgage Company (see p. 6, *supra*) is entirely consistent with this averment, demonstrating no more than common investor's prudence.

It is submitted that the language used in *Forman* to describe the profits-derivation test, particularly when read back into the *Howey* decision, where it originated, shows that efforts of others must be the source of the profits, but not necessarily the source—and certainly not the sole source—of the profits *expectation* which induced the investment. Thus, *Forman* speaks of an "expectation of profits", *to be derived* from the efforts of others. "To be derived" is language of futurity, indicating that *future* efforts of others will give rise to the profits. But since the efforts giving rise to the *expectation* of profits have already been expended, the future tense, "to be derived", is inappropriate language for describing the efforts that created the *expectation* of profits.

Compare the *Howey* formulation, where an "investment contract" was simply defined as "an investment of money in a common enterprise with profits to come solely from the efforts of others," *SEC* v. *W. J. Howey Co.*, 328 U.S. 293, 301, 66 S.Ct. 1100, 1104 (1946). It is clear that under the *Howey* formulation, only the profits need "come solely from the efforts of others", whatever may have given rise to the expectation of profits that prompted the investment. There is nothing in *Forman* to suggest an intent to change the *Howey* rule, except the elimination of the term "solely" as applied to the "efforts of others."

In striking the term "solely," the court in *Forman*, 421 U.S. 837, 852, 95 S.Ct. 2051, 2060, fn. 16, took note of the Ninth Circuit's holding in *SEC* v. *Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir. 1973) that the language, "solely from the efforts of others," should not be so rigidly applied as to preclude "securities" status for an investment contract in which the investor's own efforts made some minor contribution to profits. In

Turner Enterprises the Ninth Circuit concluded that the *Howey* "efforts of others" test had been satisfied so long as:

> the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise. 474 F.2d at 482.

Although the Supreme Court in *Forman* declined to pass judgment on the holding in *Turner Enterprises,* its consideration of that case in conjunction with deletion of "solely" from its restatement of the "efforts of others" requirement must reflect a deliberate decision to disregard inconsequential activities of investors in relation to profits. Certainly, such minor activities of an investor as a visit to a job site would not be disqualifying.

The question next arises as to whether a lender, in financing a construction project, for example, makes such a significant contribution to the success and profitability of the project that the anticipated profits from the loan will not be deemed "to be derived from the entrepreneurial or managerial efforts of others". It is this problem, and not the exercise in semantics that leads to characterization of a bank loan as a non-investment "commercial loan", *C.N.S. Enterprises, Inc.* v. *G & G Enterprises, Inc.,* 508 F.2d 1354 (7th Cir. 1975), *cert. denied* 423 U.S. 825, which casts doubt upon the "securities" status of bank loan notes in the hands of the lending bank. Adequate financing of a major construction project is not merely important, but crucial. Accordingly, a bank's entrepreneurial activities in appraising the property, evaluating market prospects, estimating construction costs, analyzing the borrower's financial resources, and realistically calculating the borrower's total financial needs, are major essentials to profitability.

But precisely because of the vital role which a bank plays in creating and managing a loan, when that same bank goes into the market place and invites investors to purchase major participations in its loan in reliance upon its expertise as a lender and loan manager, it should be held to the same standards of full and fair disclosure which would obtain if it were selling its corporate shares. This distinction between the posture of the lead bank as a commercial lender and the posture of a participating shareholder, who takes no part in the creation or management of the loan, has been recognized by the better reasoned cases and articles.

Thus, in *United California Bank* v. *THC Financial Corp.*, 557 F.2d 1351 (9th Cir. 1977), the Ninth Circuit, while holding that non-negotiable short term notes (one month) secured by receivables were not "securities," distinguished the case of a loan participation. Though criticizing as an overly "literal reading of the statute" the Fifth Circuit's decision in *Lehigh Valley Trust Co.* v. *Central National Bank,* 409 F.2d 989 (5th Cir. 1969), in which it held that a loan participation was necessarily a "security" because the statute so defined it, the *United California Bank* court went on to say:

> [T]his case [Lehigh Valley Trust] remains vital by instructing that, while the underlying note may not be a security, *the participation interest may fall within the definition of a security.* Cf. *Avenue State Bank* v. *Toutrelot,* 379 F.Supp. 250, 254 (N.D.Ill. 1974). 557 F.2d at 1357, fn. 8.

This distinction was also recognized in *Commercial Discount Corporation* v. *Lincoln First Commercial Corporation,* 445 F.Supp. 1263 (SDNY 1978), where the court held that CDC's purchase of a participation in Lincoln First's (the lead bank's) secured short term loans to Piccard was an investment in a "security":

> CDC's [the participant's] contractual relationship under this agreement was with Lincoln First [the lead bank], not with Piccard [the borrower]. CDC did not lend money to Piccard, nor did it hold evidence of indebtedness signed by Piccard. Furthermore, CDC had no direct interest in the collateral (the accounts receivable in the inventory) pledged by Piccard, though it did have a right to participate in any 'amounts received by [Lincoln First] through realization upon the specific collateral, in repayment of the principal amount of the advances' and even though Lincoln First agreed to hold the collateral 'as agent of and trustee for' CDC. 445 F.Supp. at 1265.

Differentiating the position of a loan participant from that of the lead bank, the author of a law review note states:

> Typically, the lead bank not only negotiates the terms of the loan with the client, but also actually makes the loan from its own reserves. Thus the lead is the sole party holding any documentation, collateral or rights against the borrower. After the loan has been made, the lead will then line up syndicate members, who in turn purchase a participation share evidencing a share in the loan. * * *
>
> Janik, *The Colocotronis Dispute: When Is a Loan Participation Share a Security,* 13 J. Int'l. Law & Econ. 165, 170 (1978).[11]

---

[11] See also notes, *Loan Participations as Securities,* 8 Cal. W. Int'l. L. J. 510, 520 (1978), and *Bank Loan Participations: The Affirmative Duty to Disclose Under SEC Rule 10b-5,* 27 Syracuse L. Rev. 807, 816 (Spring 1976): "The participation certificate merely symbolizes the right of the participant to share pro rata in the profits or losses derived from the venture. It gives the participant the right to proceed against neither the lead nor the borrower in the event of default."

The principal reason for treating a participation share as a "security", even though the underlying note is not, is that the participation shareholder stands at a remove from the venture being financed and must rely chiefly upon the lead bank, not only for information concerning the project, but also for management of the loan when consumated. As observed by Judge Wright in his special concurring opinion in *Great Western Bank & Trust* v. *Kotz,* 532 F.2d 1252, 1261-1262 (9th Cir. 1976):

> "While banks are subjected to risks of misinformation, their ability to verify representations and take supervisory and corrective action places them in a significantly different posture than the investors sought to be protected through the securities acts. "In an investment situation, the issuer has superior access to and control of information material to the investment decisions. . . . The commercial bank deals 'face-to-face' with the promissor [borrower]."

In like vein, see California Western Law Journal:

> [E]ven if a participating bank were to employ outside consultants and advisors, it could never put itself in the position of the informed lead lenders who work closely with the borrower in developing and supervising the loans. . . . Thus, the participants had no choice but to rely on EAB, as lead lender, for their credit evaluation and their ability to negotiate loan covenants and restrictions. Subsequent to the purchase of participations and the loan being made, reliance on EAB necessarily continues for loan surveillance and administration, 8 Cal. West. L. J. 510, 532 (1978).

As regards the rights reserved to Petitioner under the participation agreements to veto any change in the loan terms for release of the collateral and to require

foreclosure in the event of a default, those are merely the rights of any bondholder. If those minimal rights for protection of the investment were disqualifying, it would not be true as stated by this Court in *United Housing Foundation, Inc.* v. *Forman,* 421 U.S. 837, 850, 95 S.Ct. 2051, 2059 (1975) with reference to a "note, a bond, or a share of stock" that, "most instruments bearing those traditional titles are likely to be covered by these statutes."

For all of the foregoing reasons, this Petition should be granted.

Respectfully submitted,

WILLIAM A. WICK
WHITE, RAUB, REIS, WICK & RIEGNER
1000 Merchants Bank Building
11 South Meridian Street
Indianapolis, Indiana 46204
(317) 632-1348
Attorney for Petitioner

Of Counsel for Petitioner:
NICHOLAS C. NIZAMOFF
WHITE, RAUB, REIS, WICK & RIEGNER
1000 Merchants Bank Building
11 South Meridian Street
Indianapolis, Indiana 46204
(317) 632-1348